Personal Assets Trust PLC

February 2018 — Quarterly Report No. 87

'Blip' or Breakdown?

After the calm, the storm. We had been experiencing an unprecedentedly long period of stability in markets when, quite suddenly, on Friday 26 January, our compasses went haywire. Three weeks later, things seemed to have calmed down again and markets were recouping their losses. Had it been just a 'blip'? Or was it something more unsettling and sinister?

The context here is important. 2017 was an astonishing year for markets, and particularly remarkable was the unprecedentedly low level of volatility. The VIX Index (otherwise known as the *'fear index'* or *'fear gauge'*), which expresses the implied volatility of the S&P 500 index, has in recent years tended to move between a low of around 10 and a high of around 30, with 'spikes' to around 50 during temporary panics and an unforgettable 'superspike' of 80 during the worst of the financial crisis in 2008. During 2017, however, the VIX enjoyed over 50 trading days at below 10, something which had never happened before (the lowest the VIX has ever reached was 8.56, on 24 November 2017). We went into 2018 with investors' confidence at a record high, and the American Association of Individual Investors reported that individual investors' cash levels were at their lowest since December 1999. Had we at last attained to those sunny uplands where markets would rise for ever?

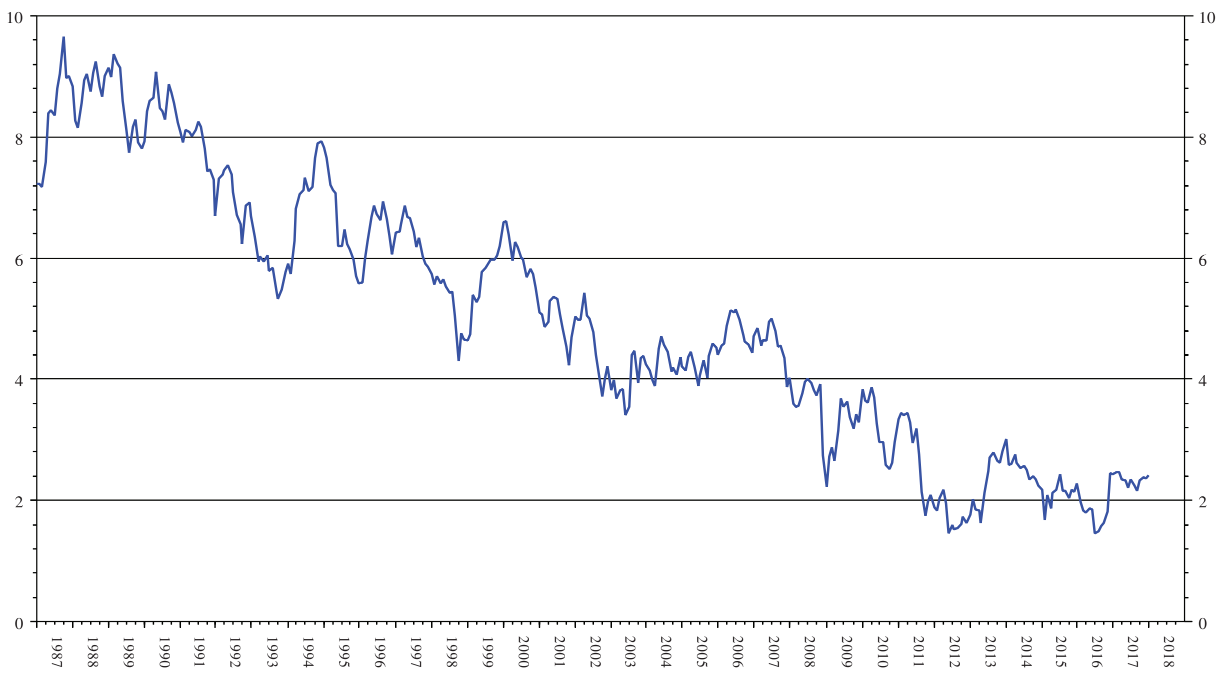
Alas, in financial markets a trend is a trend only until it stops — which trends always do. It was inevitable that such low volatility would in due course beget higher volatility, and this is what happened on 26 January and in the fraught fortnight that followed it.

During the last two years of minimal volatility it was not surprising that a favoured strategy was to 'short' volatility, while investment banks fed demand by selling leveraged financial products to facilitate this. Occasionally, one-way bets may appear in the financial markets; but this wasn't one of them — or, at least, it couldn't last indefinitely. When the VIX spiked to almost 40, 'shorting' volatility was shown to have been the financial equivalent of picking up pennies in front of a steamroller.

Staying Short

Another trend that can't last for ever is the 36-year bull market in bonds. Our eyes are glued to the 10-year US Treasury yield. The chart *(see below)* shows how this slithered downwards from over 10% in 1988 to its all-time low of 1.36% on 5 July 2016, only to clamber back up to nearly 3%. Today the chart is, in the view of Chris Wood of CLSA, *'the most important chart in the world'*, and we don't disagree: the 10-year US Treasury yield is no mere standalone number, but a reference point relative to which many other financial assets are priced. If bond yields continue to rise then the equity market, too, will come under sustained pressure as the cost of capital rises. A protracted period of rising yields would make it very difficult to protect capital other than by holding large amounts of liquidity. This is why we have kept duration short on TIPS and UK Index-Linked (our US TIPS have maturity dates ranging from five months to four years and our UK Index-Linked has a maturity of six years, which reduces their sensitiv-

US 10 Year Treasury Yield 1987 – 2018



ity to changes in interest rates) in addition to holding high levels of cash and cash equivalents. The all too real possibility of a double whammy from rising yields on equities and bonds is a major threat to 'diversified' portfolios; diversification will not provide the protection to portfolios it has in the past. This is what appears to be unfolding at the moment and may yet lead to far greater dislocation in markets. Diversification will not protect you against a hurricane, and if yields climb higher and higher and inflation takes root, neither bonds nor equities will provide any shelter,

Even if stability is restored for a time and nerves settle down, I have no doubt that there has been something bigger going on here than a mere 'blip'. We are in for a period of greater volatility, exacerbated by the growth of machine-driven algorithmic (*'algo'*) trading and related passive investment strategies such as 'smart beta'. Passive investing, seen by many as the cautious investor's best defence, is in fact the enemy within. When the index is tumbling, who wants to be a prisoner of the index? The one hope of salvation is *not* to be an index fund. Yet passive mutual funds in the US have grown in size from $0.5 trillion in 2003 to $6 trillion by 2016: potentially $6 trillion of illiquidity. Index funds, like exchange traded funds ("ETFs"), can often be price-insensitive sellers, summoning up the spectre of what Chris Wood of CLSA calls 'Judgement Day'.

'Are You Buying Yet?'

Since the end of January almost everyone I've bumped into who has an interest in investment has asked me if Personal Assets has started buying equities yet. Perhaps they're just making conversation, or maybe they think a 7% fall in markets is an irresistible buy signal, but almost certainly they haven't fully grasped just how cautious we are, and how reluctant to commit capital (our *'sacred savings'*) unless we're confident that valuations warrant it. What we have definitely *not* been doing is *'buying the dip'*. We have not seen sufficient changes in valuations to justify wholesale changes in holdings or shifts in the trust's asset allocation at this stage.

A Shareholder Asks . . .

Quite a few Personal Assets Quarterlies have had their origin in questions asked by shareholders, and recently I received a set of queries from an investor which I feel are of general interest and are worth responding to here.

Question 1. **With the largest percentage of assets either in USD or on the NYSE, should you not be tracking the S&P 500 rather than the FTSE All-Share Index?**

Answer: In running Personal Assets we don't try to *'track'* anything, and the composition of the FTSE All-Share has no bearing on the structure of our portfolio or on the investment decisions we take. What I suspect the shareholder meant is that, given our current portfolio disposition, shouldn't we use the S&P 500 as a comparator rather than the FTSE All-Share?

My answer is strongly in the negative. We use the FTSE All-Share as our comparator not because we see ourselves as running a UK fund, but because most of our shareholders are UK investors with liabilities denominated in Sterling. We therefore believe that, whatever the geographical exposure of our investments, it makes sense to compare our performance with that of UK equities, which are the natural investments for those who have Sterling liabilities and are seeking capital preservation and growth.

There are two other points here. First, just because our portfolio is at present heavily weighted towards the US it doesn't follow that this will always be the case. In future years it might be much more heavily weighted towards the UK (or, who knows, towards some other market or markets yet undreamt of). Secondly, while we are heavily invested in US securities we are not nearly as heavily biased towards the US Dollar. At 31 January 2018 we had a total of 52% of our shareholders' funds in US securities (including gold), but we had an exposure of only 22% towards the US Dollar (again including gold) while our exposure to Sterling was 70%.

Question 2. **Charts for Personal Assets against Foreign & Colonial and the S&P 500 indicate a rather uninspiring performance. I know you've commented on this previously in various reports. I'm just wondering whether the continuation of the cautionary approach is justified.**

Answer: If you'll allow me to exaggerate slightly for effect here, our chief aim in life is to be uninspiring. I've often said to would-be investors:

'Personal Assets doesn't just aim to let you sleep easily — it aims to send you to sleep.'

Personal Assets is a trust for cautious people, run with the primary aim of preserving capital. Only when we have achieved this do we look to make our capital grow. When considering how Personal Assets has performed we don't just look at NAV or share price movements (thanks to our discount and premium control mechanism, NAV and price are broadly the same). We look also at the degree of risk we are prepared to accept in achieving performance. As I wrote in Quarterly N°. 85,

'To investors who value stability and try to reduce worry to a minimum, Personal Assets offers low price volatility. Every year in our Report & Accounts we show a chart of share price performance against share price volatility (see page 10 in the 2017 Report). This shows investors not only how our share price has performed, but also how smooth a ride it has been. We may not be among the trusts which travel the farthest, but we do (we believe) offer a less bumpy ride.'

Comparing the performance of Personal Assets with that of another trust such as Foreign & Colonial is therefore not always helpful or relevant. Indeed, it can sometimes be positively misleading. A 25% rise in NAV achieved through risk-averse investing is qualitatively different from a 25% rise achieved by means of a high risk strategy. Although the end result may be the same, the means employed towards achieving it must also be examined, to ensure that they are within the boundaries of risk deemed acceptable by the Board.

Is our cautionary approach still justified? My answer is simple: yes, yes, and yes again. Times like these, when despite concerns about valuation levels markets have still tended to rise, hold a particular danger for those who have been cautious of the market for some time — namely, that of being panicked into buying equities at just the wrong moment. I don't know if you've read the sad story of Poor Grenville in *The Money Game* by 'Adam Smith' (not the eighteenth century Scottish economist and moral philosopher but the American journalist George J W Goodman), which was published half a century ago but is still full of valid insights. It was the first book I was given to read by my new employers when I entered the fund management business in 1977, and it describes a classic instance of panic buying of equities, in this case when markets were rising strongly in the late 1960s. Poor Grenville manages a $100 million fund and has gone liquid too early. Here he is confiding in a broker, Charley, who has invited some other investors to consider Grenville's predicament and give him advice.

'Poor Grenville,' said Charley, *'has gotten caught with twenty-five million in cash. It's a disaster. How would you like to have twenty-five million in cash with the Buy Signals you've just seen? Come to lunch. Poor Grenville has to lose his cash, right away.'*

Charley goes on to relate how Poor Grenville must be seen to have all $100 million fully invested if the market is coming off the floor, since his fund is *'performance-oriented'.* His $25 million in cash means he guessed wrong at the bottom of the market. He has to make up lost ground in a hurry, and he mourns to his hearers that there must surely be a logical solution. But, as 'Adam Smith' points out:

'The market does not follow logic; it follows some mysterious tides of mass psychology. Thus earnings projections get marked up and down as the prices go up and down . . Somebody must know something we don't know. With all the analysts and all the research and all the statistics and all the computers, it is still possible to be 51 percent wrong, and you can do better than that by flipping a coin. Anyway, Poor Grenville got back in the market, $25 million in one big gulp. He bought a mixture of high flyers like Xerox, Polaroid, and garbage.'

This shows that *'behavioural finance'* was known about long before it got its name. And what falls first when the market turns down? Yes, high flyers and garbage.

Question 3. **The fee for investment advice seems quite a lot to me, given so little movement in the composition of the fund.**

Answer: The thudding sound you may just have heard was that of me beating my head against a brick wall. Again and again throughout my working life I've encountered the view that the more transactions a fund makes, the more deserving the fund managers are of their fees. People often complain to me about our lack of portfolio activity. One academic economist with whom I sometimes have lunch greets me each time with, *'Have you done your one transaction this year?'*, as if all I did in the office for the rest of the time was twiddle my thumbs and surf YouTube.

But is the amount of work done by a fund manager best measured by the number of trades that have taken place within the fund? Emphatically not. Leaving aside the fact that dealing costs money and over time can cause significant erosion of capital, a high volume of portfolio changes can be as much an admission of failure as evidence of thoughtfulness and care. If the investment outlook hasn't changed, why change the portfolio you have structured specifically to benefit from that very outlook and to guard against the dangers it presents?

(Remarking on the low turnover typical of funds managed or advised by Troy, a client once asked Sebastian Lyon, our Investment Adviser, what he did all day. *'I worry,'* was Sebastian's reply.)

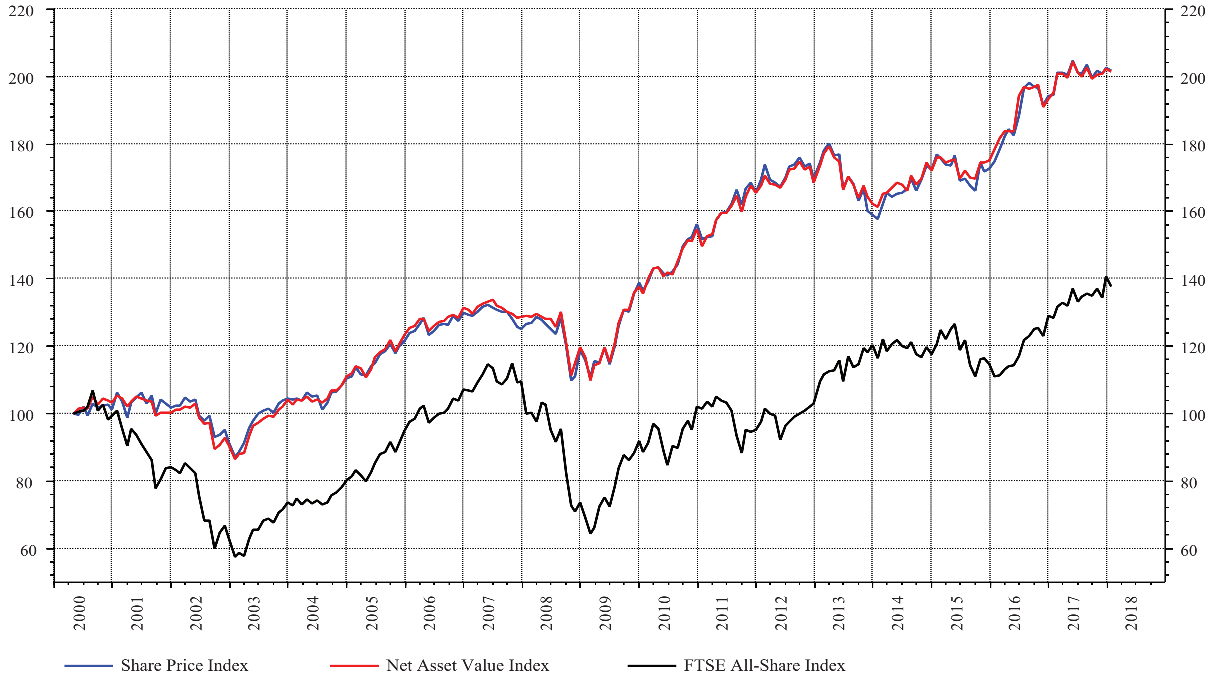
It takes at least as much work to run Personal Assets' portfolio as it would to run some straightforward stock-picking fund. We think about the stocks we hold just as much as do the managers of such funds, and we have the added dimension of having to think strategically about sectors, markets, currencies and commodities. Furthermore, while our positions in equities may not change as much as would positions in more actively managed equity-only funds, Personal Assets is not an equity-only fund and there is a lot of work and skill involved in managing our index-linked holdings and our holdings of the very short-dated (a couple of months at most) UK and US Treasuries we buy in preference to bank deposits for reasons of security, to say nothing of our currency hedges.

Once every year, the Remuneration Committee of the Board of Personal Assets considers the fees paid to Troy. Personal Assets' total costs are made up of the (largely fixed) costs of running the Company *qua* Company, and a percentage fee for investment advice. This percentage fee tapers downwards (it will fall to 0.5% of shareholders' funds over £1 billion) and for this reason the Ongoing Charges Ratio ("OCR") will tend also to reduce if the fund continues to grow in size. There are no performance fees or incentive fees. Simplicity, transparency and value for money are our aims. Our investment approach is long term, and to make money from short term trading is not our aim. We don't condemn short term trading *per se*, but it's not our style and we probably wouldn't be much good at it anyway — it's quite different as a way of investing from what we have always done.

OK, you may have heard it before; but judge us on what we say we're trying to do, rather than on what someone else thinks we should be doing. Having trained as an historian I've often taken comfort and inspiration from two generals who fought in different eras and different parts of the world: Quintus Fabius Maximus Cunctator (or 'the Delayer'), the Roman commander against the Carthaginians in the Second Punic War, and Prince Mikhail Illarionovich Kutuzov, the Russian general who fought Napoleon in 1812. Both of them refused to be panicked into acting despite immense pressure to do so, but instead husbanded their strength until the time was right for confrontation and victory. Doing nothing needed great bravery when politicians, rulers and even the generals on one's own side were clamouring for action. Ian Rushbrook and I required such courage between c. 2005 and 2007, and to a lesser extent Sebastian and I did in 2012/13. Our courage is again being tested today, but we are sticking to our guns.

ROBIN ANGUS

PERSONAL ASSETS TRUST PERFORMANCE



Source: Thomson Reuters Datastream

	Value 31 Jan 2018	Percentage Changes 1 Year	3 Years	5 Years	10 Years	30 Apr 2000
Share Price	£407.50	3.7	14.0	15.6	59.5	101.7
NAV per Share	£402.41	3.1	14.4	16.1	56.2	101.4
FTSE All-Share Index ("Index")	4,137.66	7.2	14.2	25.9	37.9	37.8
NAV relative to Index		(3.8)	0.2	(7.8)	13.3	46.2

Past performance is not a guide to future performance. The value of investments may go down as well as up and you may not get back the full amount originally invested.

TOP 10 EQUITY HOLDINGS

Company	Country	Sector	Valuation 31 Jan 2018 £'000	Shareholders' funds %
Microsoft	USA	Software	31,662	3.6
British American Tobacco	UK	Tobacco	31,323	3.6
Philip Morris	USA	Tobacco	30,227	3.5
Nestlé	Switzerland	Food Producer	28,779	3.3
Coca-Cola	USA	Beverages	27,171	3.1
Sage Group	UK	Technology	20,228	2.3
Berkshire Hathaway	USA	Insurance	19,307	2.2
Altria	USA	Tobacco	18,845	2.2
Dr Pepper Snapple	USA	Beverages	17,499	2.0
Unilever	UK	Food Producer	15,560	1.8
			240,601	**27.6**

PORTFOLIO ANALYSIS

	Valuation 31 Jan 2018 £'000	Shareholders' funds %
Equities	378,400	43.3
US TIPS	169,181	19.4
UK T-Bills	165,801	19.0
UK Index-Linked Gilts	31,045	3.5
Gold Bullion	75,936	8.7
Cash and Cash equivalents	52,961	6.1
Shareholders' funds	**873,324**	**100.0**

Further information on the Trust can be obtained from the Company's website – www.patplc.co.uk or by contacting Steven Budge on 0131 538 6605